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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

--------------- In the Matter of -----------------

PUBLIC UTILITIES COMMISSION

Instituting a Proceeding to Investigate the Issues and Requirements Raised by, and Contained in, Hawaii Revised Statutes Chapter 486H, as Amended

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CHEVRON U.S.A. INC.'S RESPONSE TO ORDER NO. 22056

AND

CERTIFICATE OF SERVICE

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CHEVRON U.S.A. INC.'S RESPONSE TO ORDER NO. 22056

CHEVRON U.S.A. INC. ("Chevron"), by and through its counsel, hereby provides its response to the Public Utilities Commission of the State of Hawaii's ("Commission") Order No. 22056 issued on September 28, 2005 which seeks (a) a marketing margin proposal further refining the class of trade approach suggested by ICF Consulting and (b) a second proposal to adjust the HRS § 468H-13 factors to include the addition of ethanol blending requirements, which would take effect on or about April 2006.

I. TRADE CLASS MARGIN

Chevron has two responses to the Commission's request for proposals further refining the class of trade approach. First, Chevron recommends that the Commission implement the spirit of the price cap legislation and remedy an unintended adverse consequence of the cap by exempting bulk sale agreements from the operation of the price cap. Second, while Chevron is not proposing any refinement in the class of trade approach and may request an upward adjustment in the 18 cpg marketing margin and the zone adjustments to account for increased costs, Chevron also urges the Commission to not take any action that might change the economics of the supply of wholesale gasoline in Hawaii in a way that may result in product being moved to markets outside of the State.

Free markets promote competition and have proven to be the most efficient and effective means to balance supply with demand, and to bring consumers reliable sources of product at prices that reflect the competitive factors in the market. Price caps interfere with the normal workings of the market and are bad public policy.

Among the many examples of this interference is the effect the price cap has had and will continue to have on term contracts for bulk supply. These term contracts are highly negotiated transactions between sophisticated commercial parties, all of whom, to varying degrees, leverage the options available to them in negotiating contract terms. The Legislature never suggested that term contracts for bulk supply — which typically have prices that are pegged to some measure of import parity — were to be targeted by the price cap regime.

Indeed, during the Commission's meeting on May 19, 2005 with Chevron and ICF, it was disclosed that the Commission did not intend to regulate bulk sales. Avoidance of interference with term supply sales contracts was apparently one reason why the Commission properly rejected ICF's proposal to regulate bulk sales.

And yet, in Chevron's experience, under the price cap a seller that is a party to a term contract may be forced to sell at capped wholesale prices that are lower than contract prices established in arms-length negotiations. This is a perverse result since it does not encourage suppliers to remain in Hawaii and certainly does not encourage new suppliers to enter the State's market. Chevron requests that the Commission confirm that bulk supply agreements are exempt from the price cap.

Since September 1, 2005, when it first went into effect, the cap has caused market distortions such as price spikes and volatility. In its report dated October 19, 2005, the Bank of Hawaii Economics Research Center stated that "it is now increasingly clear that Hawaii's new wholesale price cap law has contributed to higher gasoline prices in the islands." The Bank also concluded that "gasoline prices in Hawaii are certain to be more volatile."

The negative effect of the price cap on the State should not come as a surprise. It was foreshadowed by Mr. Jerry Ellig, Deputy Director of the Federal Trade Commission's Office of Policy Planning, when he testified on January 28, 2003, at a joint hearing of the Legislature, that "a decision to impose price controls is also, in most cases, a decision to supplant competitive forces with direct administrative intervention. A significant body of research and experience suggests that price controls have a poor record of improving consumer welfare in markets where competition is possible, and may in fact cause more harm than good in the long term." In addition, he stated that "the more consumer-friendly ways to reduce gasoline prices in Hawaii would be through policies that reduce costs and/or promote competition. Policies that may deserve further consideration include repealing Hawaii's retail anti-encroachment law, repealing the rent cap on gas stations…."

Mr. Ellig's analysis has been borne out. The price cap legislation has caused unintended changes in consumer behavior which have not been in the economic interests of either Hawaii or its residents. The public has experienced long lines at service stations, product shortages in many locations and temporary run-outs not experienced before. Hawaii's businesses, which are highly dependent on tourism, have reported business declines associated with significantly increased gasoline prices.

A once reliable supply chain to the end-consumer has become unpredictable. Since the start of 2005, and before the price cap was implemented, Chevron had experienced only one product run-out throughout the State. In the month of September alone, Chevron has experienced over 50 instances in which a Chevron-branded service station was out of product, despite Chevron incurring added expense for driver overtime and augmenting its normal delivery fleet with third party fuel carriers.

There have also been reports of consumers stockpiling gasoline in containers. This poses a public safety risk if motorists carry containers of gasoline in their vehicles or store large volumes of gasoline in unapproved containers in residential areas.

For these and other reasons, Chevron remains convinced that the price cap legislation and its interference with the normal workings of the market represent bad public policy.

Turning to the marketing margin issue, the current margin of 18 cpg and the current zone price adjustments were adopted based upon information submitted by the parties relating to costs incurred in 2004. Chevron is considering whether to file a petition under HRS § 486H-16(a) to seek an upward adjustment of the current marketing margin and zone adjustments to account for the increased costs which have occurred since the 2004 baseline year. Chevron may be in touch with the Commission as it works through this issue.

Chevron does not have data on jobber costs. Chevron will therefore defer to the jobbers to the extent the Commission seeks data specific to the issue of a defined jobber margin. While Chevron is not proposing any trade class changes in the margin, Chevron urges the Commission to not take any action concerning class of trade issues that may generate economic disincentives relating to the supply of gasoline at the wholesale level. Chevron is concerned that action by the Commission may change the economics of supplying wholesale gasoline in the State which, in turn, could result in that supply moving to other markets.

II. ETHANOL

Chevron has three points to offer in response to the Commission's request for a proposal on the recovery of ethanol blending and associated costs:

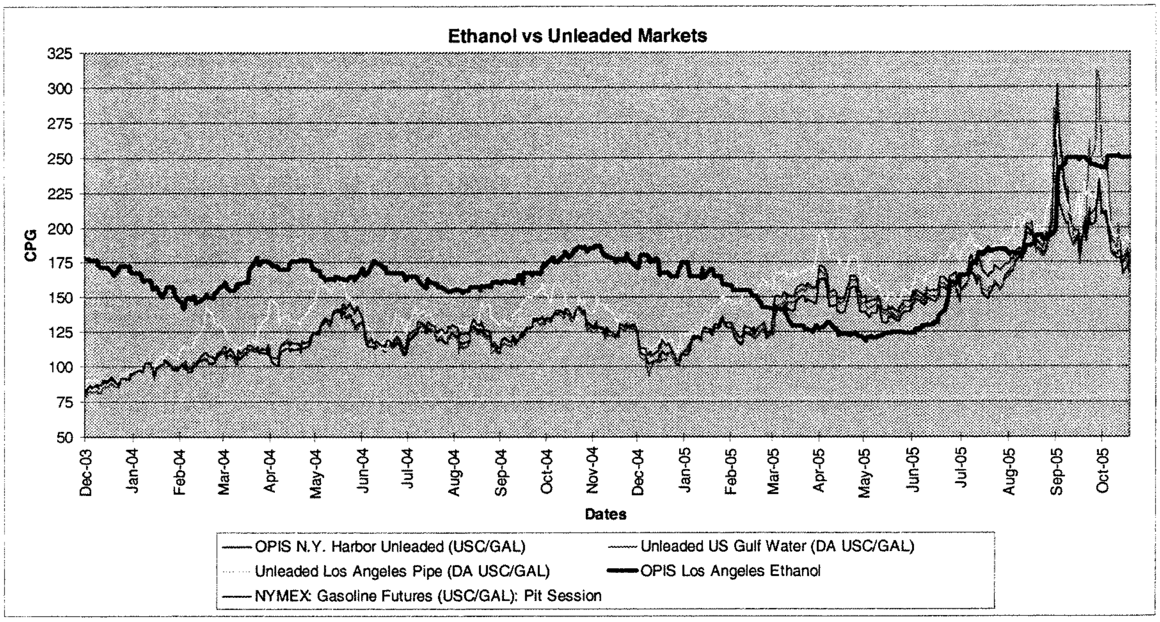
- First, while capital and other operational costs associated with compliance with the ethanol mandate are reasonably estimable at this time, the cost of importing ethanol is not. For that reason, Chevron cannot make a proposal to adjust the HRS § 468H-13 factors to include the addition of ethanol blending requirements. Chevron is concerned that, given the complexity of ethanol supply issues, it will be too difficult to develop factors under the gas price cap regime that will assure that a wholesale supplier fully recovers its costs related to the ethanol mandate.

- Second, the existence of the gas price cap as the backdrop to the implementation of the ethanol mandate exacerbates the adverse consequences caused by the price cap legislation.
- Third, Chevron is willing to meet with the Commission to discuss this highly complex situation, and urges the Commission to ask the State to undertake a comprehensive review of the price cap law and ethanol mandate.

There is no debate about the fact that the State's requirement to blend ethanol into gasoline will increase the cost of producing motor vehicle fuel in Hawaii. Significant infrastructure investments are already being made and increased operational costs will be incurred to comply with this mandate. There is also no debate that these capital costs and the other costs associated with implementation of the ethanol mandate need to be included in the price cap formula to allow for the costs to be fully recovered. Chevron agrees with ICF and the Commission in that regard.

But the situation is not that simple and, for that reason, Chevron is unable to make a proposal at this time on a formula which would allow all applicable costs to be included. Although Chevron can make a reasonable estimate of its increased capital and operational expenses for ethanol blending, the market for ethanol imports is not stable and Chevron cannot estimate transportation and import prices at this time.

The Commission needs to adopt a mechanism which accounts for ethanol price volatility. The Commission should consider a mechanism for each zone, as each will have varying transportation logistics and costs related to ethanol. As the chart below shows, there is no reliable direct correlation between ethanol pricing and the pricing of gasoline blendstock and finished product, so tying the mechanism to gasoline will not work. Supply, demand and competitive factors drive ethanol pricing, which may be impacted by weather in crop production areas, requirements for ethanol blending in other regions, cost of transportation, etc.



The Hawaiian Islands will likely be supplied by ethanol imports shipped from the West Coast, Caribbean, South America, and/or Asia. Local production, which initially will not meet total Hawaii ethanol demand, is not slated to commence until 2007, at the earliest. Due to the lack of reliable local production and limited ethanol storage availability, each cargo, the price of which will be locked in weeks before price caps are set for the gasoline with which that ethanol will be blended, will have different economics, based on ethanol product and shipping cost at the time of import. As stated in the Stillwater report, demand for ethanol in the U.S. is growing by 30MM GPY. The sourcing of ethanol will therefore be competitive, especially since this demand is growing globally, as well as domestically. Under these circumstances, Chevron cannot advise the Commission when sufficient information on ethanol purchase and transportation costs will be available to attempt to develop a costing mechanism for inclusion in the price cap.

Moreover, Chevron is uncertain that the price cap factors can assure wholesale marketers that they will be able to recover their ethanol-related costs. In an environment where the costs of acquiring ethanol and transporting it to Hawaii are, and will likely remain, unpredictable, it is unclear whether the price cap legislation will allow the full cost recovery that everyone agrees should take place.

There was no legislative effort to coordinate the State's two policy initiatives pertaining to the Hawaii gasoline market. The result is the existence of the State's wholesale price cap at the very time when suppliers will incur unpredictable costs to comply with the ethanol mandate without assurance of full recovery of those costs. One potential adverse consequence of this convergence is that gasoline suppliers who cannot fully recoup mandated ethanol blending costs in a market with a wholesale price cap may redirect product to other markets where the economics are more attractive.[1] This could potentially result in increased product shortages in Hawaii. The potential occurrence of this perverse consequence together with the other negative consequences of the gas price cap should prompt the State to undertake a comprehensive review of its price cap and ethanol blending policies.

As a separate matter, Chevron would welcome the opportunity to meet privately with the Commission to discuss this complex situation in more detail.[2]

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1 The federal low sulfur specifications for gasoline which become effective on January 1, 2006 will create additional refining and distribution costs and may be a further incentive for suppliers to move product from Hawaii to markets where the additional costs may be recovered.

2 Due to competitive concerns and the confidential nature of certain ethanol related issues, Chevron cannot provide such a briefing in an open forum. However, mindful of the Commission's rule concerning *ex parte* communications (assuming this proceeding is somehow deemed to be a contested case proceeding), Chevron would include the Consumer Advocate in any such briefing.

III. CONCLUSION

Chevron is not in a position to provide the Commission with data on jobber costs and cannot comment on trade class changes at this point other than to urge the Commission to avoid any action that might undermine the economics of supplying wholesale gasoline.

There is likewise a concern that the economics of keeping product in Hawaii will be altered if all supplier costs associated with implementation of the ethanol mandate are not included in the price cap formula to allow for the costs to be fully recovered. But Chevron cannot calculate all ethanol blending costs for inclusion in the § 486H-13 factors at this time due to the lack of important information relating to the cost of procuring and transporting a reliable supply of ethanol.

The issues raised by the Commission's Order highlight the fundamental need for a comprehensive State review of the situation created by the convergence of the gas price cap and the ethanol blending mandate.

DATED: Honolulu, Hawaii, November 1, 2005

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<u>CERTIFICATE OF SERVICE</u>

I hereby certify that on this date I served copies of the foregoing document upon the following parties, by causing hereof to be mailed, postage prepaid, properly addressed, or hand delivered, to the following:

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